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Financial Innovation and the Distinction Between Financial and Industrial Capital

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Financial innovations and concomitant changes in the focus of activity of nonfinancial corporations are blurring the distinctions between financial and nonfinancial capital. Karl Marx, Thorstein Veblen, and John Maynard Keynes all considered the distinction between financial and industrial capital analytically significant, and the distinction was centrally incorporated in their mature works. Marx distinguished between "money capital" and "industrial capital" throughout *Capital;* Veblen spoke of the different interests and roles of "captains of finance" and "captains of industry" in *The Engineers and the Price System;* and Keynes differentiated between both "speculation" and "enterprise" and "rentiers" and "entrepreneurs" in *The General Theory.*[1]

For Marx and economists in the Marxist tradition the distinction is important for two reasons. First, from the perspective of the labor theory of value, only workers employed productively in producing goods and services under the control of industrial capitalists produce surplus value; profit and interest are seen as competing claims on this surplus value. To the extent that the share of the total social capital in the circuit of financial capital were to increase, the ability of the system to expand would be curtailed because the profits of industrial capitalists are the ultimate source of funds for financing investment (the same effect

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would obtain if the ratio of interest to profit were to rise, to the extent that the interest were used to finance the financial capitalists' consumption). Secondly, Rudolph Hilferding in *Finance Capital,* and to a certain extent Vladimir Lenin in *Imperialism* saw the increase in the relative power of financial capital that occurred at the turn of the twentieth century with the rise of investment banking as contributing to an increase in the degree of concentration of ownership in the means of production; and this in turn as contributing to the rise of imperialism (imperialism was explained as due to the necessity to export the "surplus capital" resulting from the rise of monopoly power).[2]

For Veblen, the increase in the power of "captains of finance" would lead to oligopolistic behavior, especially the curtailment of output, and to a reduction in efficiency. Keynes expressed concern with the increase in the relative importance of financial speculation over enterprise (capital formation) which he thought had occurred during the 1920s. He argued that this increase in speculation had contributed importantly to the instability of the capitalist system and to the severity of the Great Depression.

Debate over the roles and relative social power of financial and industrial capital has flared up several times in the twentieth century.[3] Four important points of contention appear: who controls the nonfinancial corporation—its owners, managers, or bankers; the relative power of the two types of capital (and representative firms); the means by which this power is wielded; and the degree of interpenetration of industrial and financial capital. Most of the participants in the debates agree that there has been some degree of interpenetration of the two types of capital, and most cite the ability of financial institutions to ration credit and ownership or control over voting rights of nonfinancial corporate equity shares as the sources of the growing influence and power of the financial corporations.

This article accepts the argument that financial and industrial capital have been increasingly intertwined, and attempts to make two contributions. First, it calls attention to a mechanism other than those usually cited as contributing to that interpenetration: the shift in the focus of activity of the nonfinancial corporations from the design, production and marketing of their traditional products toward activities traditionally associated with financial corporations.

Increasingly the nonfinancial corporations used funds to finance combinations of firms, speculation in financial assets, and the extension of credit rather than to finance capital formation. This phenomena has several interesting implications. Since a large and growing proportion

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of these funds are borrowed, it has contributed to the increase in the nonfinancial corporations' leverage ratios and consequently to the increasing possibility that the U.S. economy is "financially fragile." Hyman Minsky is chiefly responsible for this argument.[4] Also, the use of borrowed funds to finance these activities, especially combinations of firms, may divert funds from capital formation. And finally (the second point the article attempts to make), the functional distinction between financial and nonfinancial corporations may be disappearing, making the debates over the relative social and economic power of the two types of capital (and firms) less relevant.

An analysis of the composition of the asset portfolios of the nonfinancial corporations, of their sources and uses of funds on capital account, and of the contribution to their profit flows made by the financial assets in their portfolios produces evidence that indicates there have been significant changes in the nonfinancial corporations' operations that have blurred the distinctions between the two types of firms. The nonfinancial corporations are increasingly assuming one of the principal functions and distinguishing characteristics of financial intermediaries—borrowing to lend. And increasingly their gross return on capital consists of interest on lending and capital gain on speculation rather than of profit on industrial enterprise.

Changes in the Balance Sheets of Nonfinancial Corporations

Financial and nonfinancial corporations are usually distinguished by the composition of their asset and liability portfolios, the sources of their incomes, or the sources and uses of funds on capital account. All of these reflect economic activities or functions.[5] A financial corporation holds chiefly financial assets (claims on income and wealth) in its portfolio while a nonfinancial corporation holds real assets. A financial corporation's profits come in the form of interest, dividends and capital gains on its financial assets, while a nonfinancial corporation's profits flow from sales of the commodities it produces with its real assets. A financial corporation is highly leveraged, using deposits or various types of debt securities as its principal source of funds (rather than its own equity capital), and it uses those funds to purchase other financial assets. A nonfinancial corporation chiefly finances its purchase of assets from internal sources of funds or through equity issue, and it uses those funds to purchase real capital (investment in the economic sense).

Although differences continue to exist between financial and nonfinancial corporations, the nonfinancial corporations increasingly resem-

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ble the financial corporations if they are compared from these perspectives. The asset composition of nonfinancial corporations can be determined from the data reported in the Federal Reserve Board's Balance Sheets for the U.S. economy. The ratio of nonmonetary financial assets (NMFA) to tangible assets (TA) (historical cost, adjusted for depreciation) stood at 45.9 percent in 1960, 48.0 percent in 1970, 53.9 percent in 1980 and 55.2 percent in 1983 (see NMFA/TA in Table 1). Thus, increasingly, the portfolios of nonfinancial corporations contain financial rather than tangible assets.

Table 1. *Financial Ratios for Nonfinancial Corporations*

	1960	1970	1980	1983		
NMFA/TA	45.9%	48.0%	53.9%	55.2%		
Average Value						
	1950s	1960s	1970s	1950-66	1967-81	
B/I	27.4%	37.2%	49.5%	30.2%	48.8%	
Average Value						
	Cycle 1	Cycle 2	Cycle 3	Cycle 4	Cycle 5	1984
	1954-58	1958-61	1961-70	1970-75	1975-80	
B/I	29.0%	29.9%	38.6%	55.2%	45.7%	52.1%
Average Value						
	Cycle 1	Cycle 2	Cycle 3	Cycle 4	Cycle 5	1983
NFA/I	23.5%	29.9%	31.3%	45.7%	40.6%	50.0%
Average Value						

SOURCES: Federal Reserve Board *Flow of Funds Accounts* and *Balance Sheets for the U.S. Economy;* National Bureau for Economic Research (Cycle Dates).[6]

ABBREVIATIONS: B is net funds raised in markets with credit instruments; I is fixed Investment; NFA is net acquisitions of financial assets; NMFA is year-end outstanding value of nonmonetary financial assets; TA is year-end outstanding value of tangible assets, valued at historical cost (all statistical concepts from the Flow of Funds Accounts).

Both the sources and uses of funds for the nonfinancial corporations have also changed. The firms' flow leverage ratios (borrowing to investment) rose during the postwar period, averaging 27.4 percent in the 1950s, 37.2 percent in the 1960s and 49.5 percent in the 1970s and early 1980s. If flow leverage ratios are averaged over the duration of the six business cycles from 1952 through 1980, we observe a strong intercyclical upward ratchet effect until the 5th cycle (1975-80), then a return to higher levels of leverage since 1980 (see B/I in Table 1).[7]

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Since the nonfinancial firms' ratios of borrowing to investment have been increasing, their other uses of funds should have been increasing over this same period. The chief "other" uses of funds for the nonfinancial firms reported in the Federal Reserve Board's Flow of Funds Table are "net acquisitions of financial assets" (this includes consumer and trade credit advanced by the nonfinancial corporations, purchases of liquid financial assets, and direct foreign investment). The ratio of net acquisitions of financial assets to investment (NFA/I in Table 1) rose through the first four cycles (from 23.5 percent to 45.7 percent) then dropped through the fifth cycle (to 40.6 percent) and rose back to 50.0 percent in 1983. It is important to understand that the Flow of Funds statistic "net acquisition of financial assets" does not include equity retirements or purchases of shares to effect mergers, acquisitions or buyouts. These are estimated by the Federal Reserve Board but are not published (the estimates are used to arrive at "net new equity issue" on the sources of funds side of the accounts); since public discussion by Fed officials of their estimates reveal these to be high and increasing in the last few years, it is probable that actual acquisitions of financial assets by the nonfinancial corporations are higher than the statistic mentioned above.[8]

The increasing weight of financial assets in the nonfinancial corporations' portfolios is reflected in an increase in the ratio of financial income to total profits for these firms. Table 2 indicates the behavior of this ratio over the period 1963–1981. Financial income (FI) is the sum of interest, royalties, capital gains and dividends received by the nonfinancial corporations as reported in the IRS annual publication *Statistics of Income;* the ratio FI/P is the ratio of financial income to the Department of Commerce's estimate for the gross profits of the nonfinancial corporations. This ratio shows a strong upward trend since 1963 (the first year for which this data is available in the appropriate form). The ratio rises from 14.9 percent in 1963 to 41.4 percent in 1970, stays flat through the 1970s (except for a peak of 85 percent in 1974—a recession year), then rises through the late 1970s and early 1980s to 84.4 percent in 1980 and 90.1 in 1981. Since interest rates had a strong upward trend during this same period, it is useful to look at the ratio of non-interest financial income to profits (NiFI/P in Table 2). This variable shows the same strong upward trend rising from 9.6 percent in 1963 to 43.1 percent in 1983. It is also interesting to notice that the nonfinancial corporate sector's share of the total interest payments received by all corporations has also trended upward—from 8.4 percent in 1963 to 14.6 percent in 1981 (iNF/iT in Table 2).

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Table 2. *Financial Income and Profits for US Nonfinancial Corporation*

Year	FI/P%	FI/NI%	i/P%	iNFI/P%	iNF/iT%
1963	14.9	15.8	5.3	9.6	8.4
1964	18.9	20.9	4.9	14.0	7.9
1965	16.3	16.5	4.1	12.2	7.0
1966	17.6	17.2	5.1	12.5	8.4
1967	20.5	35.6	6.0	14.5	8.6
1968	21.2	20.7	7.0	14.1	9.4
1969	28.9	27.4	10.6	18.4	10.8
1970	41.4	38.7	16.3	25.1	11.5
1971	35.8	34.2	12.9	22.8	10.4
1972	36.4	32.2	12.4	24.0	10.0
1973	45.5	33.3	16.3	29.2	11.0
1974	85.0	41.5	41.4	43.5	17.7
1975	41.4	30.3	16.9	24.5	11.3
1976	39.8	28.7	14.8	24.9	11.5
1977	39.2	28.8	14.6	24.6	11.6
1978	42.7	30.9	17.2	25.5	12.0
1979	60.3	36.5	25.9	34.4	13.3
1980	84.4	55.3	38.3	46.1	14.1
1981	90.1	73.2	46.9	43.1	14.6

SOURCE: Internal Revenue Service annual publication *Statistics of Income: Corporation Income Tax Returns,* 1963–1981; *Economic Report of the President,*1984, Table B-12.

ABBREVIATIONS: FI is financial income (the sum of interest, royalties, capital gains and dividends received by nonfinancial corporations); i is interest received; NiFI is non-interest financial income (FI less interest); iNF is the same as i; iT is interest received by all corporations; NI is net income for taxable purposes; P is nonfinancial corporate profits before tax as estimated by the Department of Commerce.

Summary and Conclusions

Examination of the balance sheets and sources and uses of funds for the nonfinancial corporations suggests that there has been a shift in focus on their part from the production and marketing of traditional commodities toward activities traditionally associated with financial intermediation—borrowing and lending. Several possible (and probably noncompeting) explanations for this phenomenon exist:

(1) The process may be simply an extension of a secular tendency toward an increase in the degree of consolidation of capital, noticed by Marx in the nineteenth century.

(2) The reduced profitability of traditional nonfinancial activites in the last decade may have encouraged U.S. nonfinancial corporations to look elsewhere for profitable endeavors.[9]

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(3) The high rates of interest resulting from the inflation of the 1970s and tighter monetary policies may have interacted with (2) above to make borrowing to lend attractive to the nonfinancial corporations.

(4) Changes in the financial sector characterized as *financial innovation* (new types of financial intermediaries, financial products and services, and financial assets), in the context of a regime increasingly sympathetic to regulation of the financial sector may have both allowed and encouraged the phenomenon.[10] The nonfinancial corporations discovered that they could use their credit ratings and financial power to raise funds at rates that allowed them to make a high return on their own lending and speculation in financial assets (for example by selling commercial paper to make consumer loans, issuing "junk bonds"—low grade securities—to finance acquisitions, and purchasing financial intermediaries to enter financial markets—Sears' acquisition of Dean Witter Reynolds, for example). Exploring the relationship between financial innovation, deregulation and the increasing interpenetration of financial and industrial capital appears to offer fruitful opportunities for research which might be instrumental in bringing to a fuller understanding the trajectory of the U.S. economy in the future.

Notes

1. Karl Marx, *Capital* (New York: International Publishers, 1967), Volumes 1 and 3 use this distinction; Thorstein Veblen, *The Engineers and the Price System* (New Brunswick: Transactions, 1983), see Chapters 2 and 3; John Maynard Keynes, *The General Theory of Employment Interest and Money* (New York: Harcourt Brace Jovanovich, 1964), Chapter 12.
2. Ruldolph Hilferding, *Finance Capital* (Boston: Routledge and Kegan Paul, 1981); V. I. Lenin, *Imperialism* (Moscow: Progress, 1968). See Ken Woodword's review of *Finance Capital* in *Social Concept* 1 (May 1983): 55–70.
3. For summaries of these debates see David Kotz, *Bank Control of Large Corporations* (Berkeley: University of California, 1978: Chapter 1; and Edward Herman, *Corporate Control, Corporate Power* (Cambridge: Cambridge University Press, 1982).
4. Hyman Minsky, *Can "It" Happen Again? Essays on Instability and Finance* (Armonk: M. E. Sharpe, 1982); Chapters 3, 4, 5, and 6.
5. See the definition of a financial intermediary in any standard money and banking text such as Robert Auerbach, *Money, Banking, and Financial Markets* (New York: Macmillan, 1985): 49–50.
6. Christopher J. Niggle, *The Cylical and Long Run Behavior of Leverage for the U.S. Nonfinancial Corporate Sector 1953–81: A Sources and Uses Approach.* Ph.D. diss. (University of California, Riverside, 1984).
7. Ibid. This work discusses the behavior of leverage ratios for the nonfinancial corporate sector.

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8. See the statement by Preston Martin, Vice Chairman of the Board of Governors of the Federal Reserve System *Federal Reserve Bulletin* 71 (July 1985): 514–17.
9. Bob Pollin has investigated the relationship between declining profitability and the increased willingness of the nonfinancial corporations to borrow funds. See his Ph.D. dissertation *Corporate Financial Structure and the Crisis of U.S. Capitalism* (New York: The Graduate Faculty, New School for Social Research, 1982) and "Alternative Perspectives on the Rise of Corporate Debt Dependency: The US Postwar Experience," *Review of Radical Political Economy,* forthcoming.
10. Gary R. Evans, "The Long Run Endogeneous Money Supply," *Journal of Economic Issues* 18 (June 1984): 66–74 discusses financial innovations in the 1970s.

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